Recommendation of "Best Practices" for and Respect to *The Future of Responsible Sub-prime Mortgage Lending*

Prepared and Presented by the

Committee on the Underserved
(a subgroup of the)

President's Advisory Council on Financial Literacy

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Introduction

With all the attention presently focused on solving the sub-prime mortgage crisis, there is a very real possibility that lending to the poor, the under-served and even the middle class might effectively dry up. This would not be good for America.

Furthermore, it could be argued that responsible sub-prime mortgage lending has done more to lift the poor out of poverty than anything else over the past 50 years. The problem has been irresponsible, predatory and greed-based sub-prime lending, and the massive financial illiteracy that fuels it, and not sub-prime lending itself.

On May 28, 2008, a meeting of the Committee on the Underserved, a subgroup of the President's Advisory Council on Financial Literacy, was held at the U.S. Department of Treasury. The Committee was joined by an expert group of topical and industry leaders representing government agencies, community development organizations, research groups, and the private sector. For the purpose of this project and subsequent "best practices" report these individuals and institutions are referred to herein as Expert Advisors to the Committee. The meeting was opened with remarks from U.S. Treasury Under Secretary, Robert Steel, U.S. Comptroller of the Currency, John C. Dugan and U.S. SEC Commissioner Paul Atkins. Subsequent to the meeting, written statements were submitted by U.S. Office of Thrift Supervision Director John M. Reich and U.S. Small Business Administration Associate Administrator Anoop Prakash (See Addendum 4).

The goal of the meeting was to: (1) identify and to differentiate responsible and irresponsible sub-prime mortgage lending, (2) outline what a responsible sub-prime loan product might look like in the future, and (3) identify what financial literacy initiatives would be needed to address the massive levels of financial illiteracy that contributed to the current sub-prime crisis. Other related environmental issues, such as disclosures and intermediaries, were also explored at the meeting.

Based on feedback received at this meeting, this report summarizes the Committee's recommendations of "best practices" to the full U.S. President's Advisory Council on Financial Literacy.

Background

The President's Advisory Council on Financial Literacy has formed five committees. The Committee of the Underserved has called a series of meetings to solicit input from experts in mortgage finance and regulation.

The initial meetings focused on the appropriate parameters of responsible and sustainable sub-prime mortgage products and services. The input was used to craft a set of policy recommendations on the future of sub-prime lending practices. These recommendations will be submitted to the full President's Advisory Council on Financial Literacy for its consideration. Under Executive Order 13455, the full Council will issue formal recommendation through Treasury to the President.

The purpose of this report is to focus needed attention on what can be done about irresponsible and predatory practices in sub-prime lending, particularly as it relates to the financial illiteracy of many sub-prime borrowers. More so, the intent of this effort is to help insure that *while many are focused on the issues surrounding irresponsible and predatory lending practices, the country simultaneously charts a responsible path forward, insuring that basic credit access continues on some reasonable basis, to groups from the credit worthy yet credit challenged, to those low-wealth, to the middle class.*

The goal then is for the Committee to put forth a series of "best practices" policy recommendations to the President through the Secretary of the Treasury with respect to the future of responsible sub-prime mortgage lending.

Framing the Issues

The following outlines and frames the context around the Committee meetings and discussions, held by the Committee with its members, advisors and expert advisors with respect to the future of responsible sub-prime mortgage lending.

Challenges for Discussion:

1) Products
- What efforts can be made to better identify and differentiate responsible and irresponsible sub-prime mortgage lending?
- What should a responsible sub-prime loan product look like?

2) Disclosures
- What efforts can be made to increase the effectiveness of disclosures?
- How can mortgage products, disclosures and other related mortgage factors become "teachable moments" for the sub-prime consumer?

3) Financial Literacy
- What types of financial literacy initiatives are needed to help mitigate the possibility of another sub-prime mortgage crisis?
- How can the nation's private and public sectors better deliver financial literacy initiatives to the sub-prime borrower?

4) Intermediaries
- What is the ideal role of lenders, servicers, brokers and regulators as it relates to educating the sub-prime borrower?
- What can be done differently now to improve things?
- What long-term action steps should be taken to reach the ideal state?

BEST PRACTICES

Responsible Sub-prime Product Strategy

The members on the Underserved Committee and expert advisors have focused on potential elements to better identify and differentiate responsible and irresponsible sub-prime mortgage lending. The Committee members recommend a new, innovative mortgage product strategy that incorporates a financial literacy life cycle from the shopping phase through the life of the loan, simplified disclosures and educational comparative illustrations of responsible sub-prime products/rates/fees, as well as positive performance incentives for both consumers and lenders/servicers.

The input the Committee received from a series of product, disclosure, intermediaries and financial literacy working groups is reflected in this best practices report.

All Committee members agreed to a holistic approach in developing responsible sub-prime lending products; one that can benefit all consumers.

Product A is designed as a baseline, universal mortgage entry product, and provides a solution most appropriate for the first-time and credit-challenged borrower.

Product B builds from Product A, with added complex features and more options (a broader choice) that fit more sophisticated borrowing needs.

Mortgage Loan Product A (Universal Entry Product)

This product is outlined with simple features that encourage, but do not require, homebuyer/homeowner advice. These features include:

- A fixed rate, fully amortizing mortgage with a term of up to 40 years.

- Minimum one month PITI (principal, interest, tax, insurance) in required borrower cash reserves at closing (borrower's own funds).

- Standard verification of income and assets.

- Borrower would be required to have a minimum down payment.

- A Life Event Clause. For borrowers with good payment performance, under certain circumstances borrowers would be allowed to skip a payment (or payments) for certain specified "life event" reasons, with the amount of missed payments added to loan principal. One approach would be to provide one "payment holiday" for every specified period of months with good payment history.

- Determination of the borrower's ability to repay. Appropriate underwriting parameters are critical for borrowers with an established, but blemished, credit history. The risk factors should be carefully balanced and include the borrower's credit score, debt payment capacity (debt-to-income ratios), post-close liquidity, etc.

- Borrower's with thin credit files and/or non-traditional credit history should be underwritten in a manner that takes into account a borrower's non-traditional payment history profile – that is, their fixed or regular payment obligations that are not reported to the credit bureaus (e.g. rent or utilities, as well as other periodic payment obligations, e.g. alimony, child support, or remittances).

- A simplified disclosure of terms delivered to borrower early in the process. Note: A one to, maximum, four pages, easy to understand form at the loan shopping stage, with the most pertinent information summarized on page one.

- No prepayment penalty.

- Pre- and post-purchase counseling options to be made available, but are not required for this loan product.

- Ongoing best practices to maintain payment discipline. The ongoing best practices should include, for example, providing periodic free credit reports to help manage credit, with access to credit education specialists that can answer questions about the reports. In addition, education should be provided about banking products that can make money management routine and effective for the borrower.

- A Financial Literacy Scorecard review would be required for this loan product; helping to ensure that borrowers understand the basic terms of the transaction, including a clear differentiation of and between "payment" vs. "interest rate." Note: per example enclosed.

- No negative amortization or pay option features allowed.

Mortgage Loan Product B

A responsible sub-prime product (Product B) could have all the features of Product A with the following ones varying: Please note that borrower education/advice is also required for Product B with additional focus on the more complex features.

Varying Product Features/Terms of Product B:

- Variable interest rate. This would include options of an adjustable interest rate (6-month or annual payment adjustments; payment shock must be limited, e.g., no more than 1% change in rate each 6 months or 2% annually, with a lifetime cap of 6%) or a hybrid adjustable interest rate (the fixed payment period must exceed three years to mitigate payment shock). Teaser or initial rates on adjustable and hybrids should not be allowed to be substantially below the fully indexed rate and subsequent rate and/or payment adjustments should be limited to reasonable levels.

- Prepayment fee would be allowed, with full disclosure for the borrower on terms and interest rate with and without prepayment fee. Prepayment fee would be limited, such as a 3-2-1 (3% fee first year, 2% second year, 1% third year), so that deeply discounted initial rates are discouraged.

Additional Loan Origination Requirements:

- Borrower Disclosures are provided and explained through homebuyer/homeowner financial education. In addition to those disclosures provided for Product A, Product B disclosures also include projected mortgage payments in different rate scenarios - demonstrating reasonable and manageable payment adjustments.

- Underwriting, which ensures the borrower's ability to repay, also includes for Product A that the loan is underwritten/qualified based on fully amortized payment.

Allowable "Product B" Enhancements

- Interest-only

- Buy-downs of initial interest rate

- 100% financing, including down-payment assistance programs

- First and second simultaneous mortgages, in conjunction with credit policy/underwriting decision and maximum combined loan-to-value ratios. (A maximum loan-to-value ratio will require further review.) This enhanced structure requires homebuyer/homeowner financial education on the specific features and terms for both the first and the second mortgage, as well as projected payments in different rate scenarios demonstrating reasonable and manageable payment adjustments.

Addendum One

Other Good Ideas

- The overarching goal is to move consumers from sub-prime borrowing to become a prime borrower. Every participant in the mortgage process should be held accountable in making this happen. By establishing compensation based on the demonstrated performance in making loan payments, the originators or brokers and servicing representatives would be encouraged to follow best practices.

- Therefore, the Committee recommends that these incentives should be implemented by: 1) withholding a portion of originator sales commission until payment performance has occurred, 2) a reduction in GSE guarantee fees for loans where the borrower has received certified financial education, 3) a reduction in fees/rate for borrowers who have received certified financial education, and 4) GSE/investor compensation to servicers for financial education and servicer prompting of borrowers to make payments to help establish good payment practices.

- Financial education should be done face-to-face, over the telephone, and financial education resources and contacts should be listed and provided at all points of the mortgage process and in all mortgage materials.

Addendum Two

Financial Literacy Scorecard

- Scorecard used at time of application
- Scorecard used at time of lock (with final loan terms)

Mortgage Loan Terms	Explanation	Customer Understanding Score
Product Description	• **Do you understand the specific loan parameters that apply to your mortgage application?** • You have applied for a fixed rate, fully amortized mortgage loan with a term of XX years. • This means the payments will progressively pay back the full amount of money borrowed, plus all interest due, within the loan's XX year lifespan.	
Loan amount and rate Information	• **Are you aware that your loan amount will be $___________?** • Estimated closing costs will be $___________. • Estimated prepayment costs $___________. The Interest rate will be fixed for a period of XX years with a rate of X (This rate is an estimate until such time that you have locked in your loan).	
Prepayment (if applicable)	• **Do you understand that this loan includes a prepayment penalty?** • This means that if you fully repay your loan for any reason a prepayment penalty will be assessed to you. The penalty amount will depend on when during the prepayment period the loan is fully repaid. • (Formula not the same in every state. State restrictions apply)	
Cash Reserves Required at closing	• **Are you aware that we will require one month's estimated principal, interest, taxes and insurance payment in cash reserves at closing?** • This means that you will be required to provide documentation to verify available funds of $XXX dollars is a savings or checking account, (stock or	

	401K can be used). We need to verify this amount of funds.	
Your Income & Assets	• **Do you understand that your income and assets will be verified?** • If you are self-employed, you will be required to provide 2 full years of complete tax returns with a signed 4506-T form and a copy of your business license. • If you are a salaried worker, you will be required to provide a current pay stub (within the last 30 days) and 2 years of W-2's. • You will be required to provide your most current bank statements to verify your assets. This is used to verify your down payment and closing costs.	
Full escrowing of property taxes and property insurance by the servicer.	• **Are you aware that your monthly payment will include $XXX for property taxes and property insurance in the amount of $__________?**	
Down Payment	• **Do you understand that you will be required to provide sufficient assets for the down payment?** • Based on your loan approval, you will be required to provide $00,000 as a down payment.	
Payments & Debt to Income Ratios	When looking at your projected mortgage payment and existing debt, (lender name) uses ratios such as "XX and XX" to determine whether you qualify for the loan. These are commonly used ratios. In the case of "XX and XX," the XX refers to the percentage of your gross income (before taxes) that may be spent on housing expenses, including principal and interest on the mortgage, real estate taxes, and insurance. The XX refers to the income that may be spent for payments on all your debts (including the mortgage): the monthly payments on your outstanding debts, when added to the monthly housing expenses, may not exceed XX percent of your gross income. Does this make sense? • PITI: (spell out the customers projected principal, interest, taxes and insurance here) • Debts used for qualifying: (list out) • Are you aware that your housing payment is increasing by $XXX?	

Nontraditional credit or thin files	• **Are you aware that we may require additional documentation to complete your payment history profile?** • Such documentation could include utility bills, rent, auto insurance, and alimony or child support payments.	
Pre- and post-purchasing counseling availability.	• (Steps to Success program – wrap more definition around this) • Ongoing best practices to maintain payment discipline (e.g., provide credit score periodically tied to counselor availability, if necessary). Pre-counseling could include discussions around fixed rates vs. ARMs, prepayment penalties (the positive and negative aspects of a prepayment penalty), closing costs. Post-counseling could include discussions on importance of paying on time, increasing credit score, ability to refinance into a prime loan,	
Payment Performance Plan	• **Are you aware that we offer a special good payment performance plan?** • This means that you may be eligible to skip a payment under special circumstances. In doing so, this skipped payment will be added to your principal balance. This means that your principal balance will increase. (Spell out life events to avoid customer abuse of the program).	

Addendum Three

A special thank you to all parties that lent their expertise and time to the Committee on the Under-Served for the purpose of exploring the Future of Responsible Sub-prime Lending. A full List of Expert Advisors to the Committee follows:

Bank of America
Bank of the West
Consumer Bankers Association
Fair Isaac Corporation
Federal Deposit Insurance Corporation
Federal Home Loan Bank of San Francisco
Federal Housing Administration
Federal Housing Finance Board
Federal Reserve Board
Ford Foundation
Genworth Financial
Ginnie Mae
Greenlining Coalition
Housing and Urban Development
Identity Theft Assistance Corporation
Independent Community Bankers of America
Mortgage Bankers Association
National Association of Affordable Housing Lenders
National Community Reinvestment Coalition
National Credit Union Administration
Neighborhood Housing Services of America
NeighborWorks America
N.Y. State Banking Department
Office of Federal Housing Enterprise Oversight
Office of the Comptroller of the Currency
Office of Thrift Supervision
Operation HOPE
Sallie Mae, Inc.
Securities and Exchange Commission
The Financial Services Roundtable
The Charles Schwab Corporation
U.S. Department of the Treasury
U.S. Small Business Administration
Washington Mutual
Wells Fargo Home Mortgage
White House Office of Faith-Based and Community Initiatives

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FDIC
Michael Townsend, Vice President
Legislative & Regulatory Affairs
Charles Schwab & Company
Cara Heiden, Co-President
Wells Fargo Mortgage
Bill Longbrake, Vice Chairman
Washington Mutual
Chairman, Housing Policy Council
The Financial Services Roundtable
Ken Wade, President
NeighborWorks

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John Dugan
Comptroller of the Currency
Office of the Comptroller of the Currency
Paul S. Atkins
Commissioner
Securities and Exchange Commission
John M. Reich
Director of Office of Thrift Supervision

Addendum Four

Remarks at the President's Advisory Council on Financial Literacy Subcommittee Meeting on the Future of Responsible Sub-prime Lending

Robert K. Steel
Under Secretary for Domestic Finance
U.S. Treasury Department

Washington- Thank you and good morning. Let me first congratulate you on a timely and important meeting. I especially want to thank the President's Advisory Council on Financial Literacy and the Subcommittee on the Underserved for organizing this meeting.

In particular I want to thank the subcommittee chair, John Hope Bryant, as well as Council members Sharon Lechter and Ignacio Salazar for their efforts to cast more attention on the underserved, and subcommittee member Rev. Dr. Robert Lee, who could not be with us today, for his efforts in this area. And I also want to thank you, our meeting participants, for agreeing to focus on this important work.

When John called me about the Subcommittee's plans for today, he spoke about how today's mortgage problems are a clear example of the need for financial literacy. I wholeheartedly agree. But what I especially liked about today's meeting is your focus on the underserved and encouraging access to financial services to continue for credit-worthy Americans, even as we work through these challenging times in our financial markets.

Now let me turn to the main themes of today. We have seen financial innovation in the mortgage market. We have seen how that innovation benefits the U.S. economy and U.S. homeowners. Many Americans became homeowners because of these financial innovations.

Unfortunately many Americans do not have access to mainstream financial services. They lack the requisite understanding to utilize financial tools and products to manage their financial affairs properly. Additionally, as financial institutions revise their lending standards, some credit-worthy borrowers could find it more difficult to access the credit needed to finance their futures. As our markets move forward, they will need to find the right balance of improving their own lending practices, while not cutting off responsible, credit-worthy borrowers.

There are more financial products available now than ever, but these products have become more complex and challenging for all of us to understand. And as consumers, we need to know more than our parents or grandparents did, if we are going to employ these financial products successfully.

For the underserved, who by definition are not using many mainstream financial services, the barriers to understanding complex financial products are high. Many lenders do not clearly explain the terms of their complex loans and borrowers have infrequent or no experience with these products. These combined factors lead to a lack of participation, which continues a downward cycle for the underserved.

This creates an ongoing responsibility for us. We can see the true value of financial education by observing what happens when it is absent. In the last few years too many Americans either chose or were put into mortgages that were not appropriate for their financial positions. And without an adequate base of financial knowledge, too many consumers entered into loans that were difficult to understand. These trends were especially pronounced among sub-prime borrowers.

Avoiding preventable foreclosures is in the interest of all homeowners. We must reach homeowners who are struggling, reach them early, and reach them with information and hope. Although many mortgage industry leaders have stepped up their efforts to reach delinquent borrowers, too many distressed borrowers are still uncomfortable speaking to their lenders. This stems in large part from lack of financial education. In fact, we learned that 50 percent of foreclosures occur without borrowers ever talking to their lender or to a mortgage counselor.

We want distressed borrowers and lenders to work together and find a way to keep people in their homes. To do so we forged a coalition of mortgage servicers, counselors and investors that are working to avoid preventable foreclosures and to improve the functioning of the mortgage markets.

This, as you know, is our HOPE NOW initiative. Through this effort we are helping distressed borrowers by connecting them with mortgage counselors. To reach more Americans, HOPE NOW continues to broaden a public service announcement campaign, to spread the word that hope is only a phone call away.

We are also looking to the promise of financial education over the long-term. Financial education is preventative in nature. The best approach is to help people avoid difficult situations from the start.

By working with the type of private sector groups like the ones we have assembled here today, we can help Americans help themselves. More Americans can and should learn more about their money, and, in turn more about financial products.

A more financially literate consumer base – across all income levels and in prime and sub-prime markets alike – could have mitigated at least some of our current housing difficulties. Financial knowledge makes people better informed consumers. And when they understand the terms of a mortgage loan, they are better able to compare the costs and benefits of different products and they are better positioned to make long-term decisions that advance their financial goals.

With that in mind, and with an eye on the long-term view, the subcommittee will ask you today to consider what policy recommendations it should present to the President's Council to address some of these challenges. In particular, the subcommittee will ask you to think about potential solutions to questions such as: How can we better identify and differentiate responsible and irresponsible sub-prime mortgage lending? What types of financial literacy initiatives are needed now to lessen the possibility of another round of turmoil in the sub-prime mortgage market? How can the private and public sectors deliver financial education programs directly to the sub-prime borrower? What should more effective disclosure from lenders look like? And what are some of the best ways we can capitalize on "teachable moments" to make sure this and other important lessons are taught? And, just as important, how can we measure success?

Through better disclosure from lenders, improved products for consumers, and increased financial education for borrowers, we can encourage a vibrant, mainstream marketplace for credit-worthy borrowers looking to finance an education, to experience the dream of responsible homeownership, and to have the opportunity to turn other lifetime goals into reality.

When it comes to educating the sub-prime borrower, there are ideal roles for lenders, servicers, regulators and other organizations to play. The questions you discuss today are important to the President. This discussion complements other work happening within the federal government, such as the Federal Deposit Insurance Corporation's upcoming conference on lending for low and moderate income families.

We recognize that financial literacy cannot immediately fix all our problems. But as I mentioned, it is part of the long-term solution. It is the preventative medicine that will help today's underserved avoid tomorrow's financial problems.

Thank you for lending the council subcommittee your time and your energy. You are part of a growing movement to create a more financially literate nation. Thank you.

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Commissioner Paul S. Atkins
U.S. Securities and Exchange Commission

Thank you very much for your kind introduction, Dan [Iannicola]. It is a privilege to be here as a member of the Securities and Exchange Commission, although I must note that the views that I express today are my own and do not necessarily reflect those of the SEC or my fellow Commissioners.

Earlier this year, President Bush made financial literacy one of his top priorities. In creating the Advisory Council on Financial Literacy, President Bush said "if we want America to be as hopeful a place as it can be, we want people owning assets. We want people investing. We want people owning homes. But oftentimes, to be able to do so requires literacy when it comes to financial matters. And sometimes people just simply don't know what they're looking at and reading."[1]

I applaud the efforts of the Council's chairman Chuck Schwab, vice chairman John Hope Bryant, and the other members of the Council who have volunteered to provide their time and effort for this initiative. This is truly a partnership - one among the public and private sectors, for-profits and not-for-profits, and academia and business. Thanks also to Bob Steel and Dan Iannicola for their time and leadership.

One of my favorite volunteer activities as an SEC Commissioner is assisting with the SEC's investor education efforts. I have visited with military servicemen and women here and abroad, senior citizens, hurricane victims, students from grammar school to college, and others to talk about the importance of investing and ways to avoid some of the common investment scams and pitfalls. Individuals contribute not only to their own economic prospects, but to the growth of the economy as a whole, by making wise investment decisions. They provide capital for innovation, mortgages, dreams, and risk-taking. In turn, a strong economy means more jobs, more opportunities, and more chances for people to accumulate capital for a business venture, build a strong retirement, put money away for education, save for health issues, or provide the seeds to realize the dreams for their children's futures.

Congress gave the SEC three objectives for our mission: to protect investors; to maintain fair, orderly, and efficient markets; and to facilitate capital formation. Borrowers and lenders alike benefit from sound lending practices - that goes for any market, be it prime, near prime, or sub-prime. Today's lender is not necessarily a loan officer at a local bank with knowledge about a particular borrower and piece of property. Due to financial innovations such as securitization, today's lenders that supply funding for mortgages may be located across the globe. A loan may pass through several intermediaries before it finally comes to rest with the ultimate lender.

In recent years, we saw the supply of capital for sub-prime loans dramatically increase credit for people for whom a home mortgage was previously not available. But such credit can quickly disappear if the lenders have little or no confidence in the stated quality of those loans. Likewise, the soundness of the instruments that investors buy, and the disclosures and the ratings on those investments, depend on the quality of the lending practices in the first place. If borrowers do not understand what they are buying and cannot fulfill the terms of their agreement from the beginning, the disclosures may not be sufficient and the ultimate lender may not be pricing the risk of the instrument appropriately. Surprises to the ultimate lenders - the investors - can result in the lack of investor confidence. Capital consequently becomes more expensive or more difficult to obtain. We have certainly seen this situation in the past year or so.

The SEC is actively investigating a number of cases involving possible securities fraud stemming from inappropriate sub-prime lending practices and sales practices in the capital markets. Maintaining a healthy and active market for securities that fund the mortgage and other credit markets remains an important concern of the Commission.

I look forward to the discussion today, and I thank all of you for attending this important meeting. Thank you very much.

Office of Thrift Supervision Press Release

Director Reich Supports President's Council on Responsible Sub-prime Lending

Washington, D.C. — Office of Thrift Supervision (OTS) Director John Reich commended the President's Advisory Council on Financial Literacy today for focusing on ways to foster responsible sub-prime lending.

"Homeownership remains the bedrock of strong communities and responsible sub-prime lending helps more Americans become homeowners," Reich said. "It is important that as we strive to prevent the abuses of predatory lending, we do not close the doors of opportunity to credit-worthy sub-prime borrowers and deprive them of the chance to pursue the American dream of homeownership."

The Committee for the Under-Served, a subgroup of the Council, met today with experts in mortgage finance and regulation to discuss financial literacy initiatives and to explore responsible and sustainable sub-prime mortgage lending. Montrice Godard Yakimov, OTS Managing Director of Compliance and Consumer Protection, attended the meeting for the OTS.

The Committee will use the input from the meeting to craft recommendations for the full Council.

Anoop Prakash
Associate Administrator
U.S. Small Business Administration

Thank you, it's a pleasure to be here on behalf of Steve Preston and Jovita Carranza.

After the fallout of sub-prime mortgages, it's of some concern that sub-prime lending has become a very negative term, particularly in the press. But I think that we can all agree that sub-prime lending is a vital way of getting capital to many people who need it, and who will use it productively.

The SBA has an important role in promoting responsible sub-prime business lending. We guaranty loans to small businesses. In the last fiscal year, we approved more than $20 billion in small business loans, and we have a total portfolio of around $85 billion in guarantied loans and investments.

The SBA's job is to make sure that capital is available to deserving small businesses.

We offer a broad range of products, from micro-loans up to $2 million loans for most projects – and as high as $4 million for certain long term fixed asset loans.

It's safe to say that everyone who receives an SBA-backed loan is considered a sub-prime borrower. In fact, one of the conditions to be eligible for an SBA-guarantied loan is that borrowers have not been able to secure their loan without our guarantee – this is called our "credit elsewhere test."

We understand how critical it is to get financing to these deserving small business owners. This is the capital they need to invest in and grow their business, and to create jobs and drive economic development.

SBA provides broad guidance on the balance between the needs of the business borrowers and the interests of the lender.

Our loan products provide a very important service to sub-prime current and aspiring small business owners. There's another very important feature of these loan programs, and that is built-in protection against predatory lending. We have a cap on the interest rate that can be charged on an SBA-backed loan. For our primary loan product – what we call our 7(a) loan – that rate is prime + 2.25%, or prime + 2.75%, depending on maturity.

We also have a cap on fees that lenders can charge. And fees that are incurred through the program are very reasonable.

We have a very important role in driving capital to deserving sub-prime small business borrowers. And our role is all the more important, given what we're seeing in the lending market, and what some of our lenders have been telling us. The trends that we're seeing really emphasize why SBA's role in the small business lending market is critical. Let me explain:

- Broadly speaking, credit is tightening, and our economy is in a turbulent time. We're seeing this affect small business.
- Specifically, we have noted two trends:
    - First, the demand for small business loans has declined,
    - Second, some lenders have tightened their credit standards.
- Lower demand is one response to generally sluggish economic conditions.
- Confidence in the economy is particularly important for small businesses. When they decide whether to invest in expanding their business, and whether to take on new debt to do so, business owners want to be confident that the economy will be strong and customers will continue spending.
- We've seen some evidence that confidence among small business owners has declined in recent months, as concerns about the economy have increased.
- Many lenders that we've talked to have indicated that this uncertainty has resulted in reduced demand.
- This is backed up by the Federal Reserve's Senior Loan Officer Survey, which shows one-fourth of both large and small domestic banks saw weaker demand for loans from small firms.
- At the same time, we are seeing a tightening of credit standards by many lenders.
- According to the Fed's April 2008 Senior Loan Officer Survey, about 50 percent of lenders reported tightening their lending standards on business loans to small firms. That compares to about 30 percent of lenders who reported tightening standards on these loans in January.
- Another important point from the survey is that 70 percent of lenders reported tightening lending standards for home equity lines of credit since January. Home equity loans have traditionally been an important source of capital for small business owners.

Even though we've seen some of our lenders tighten their credit standards, the SBA has not tightened ours. Our loan programs are well funded, and we are consistently working with lenders and business borrowers alike to improve lending and borrowing patterns.

First, we're reaching out to our lending partners, encouraging them to be better stewards of the program. We've held lender roundtables in ten cities in the past five months. When combined with our other outreach efforts, we have talked to close to 1,000 lenders during this period.

The Administrator and senior staff are committed to ambitiously reaching out to lenders and engaging lenders.

We're letting them know about some of the improvements that we've made to our lending program. We have, for instance, a new, streamlined standard operating procedure that is easier for lenders to use.

We've also made some other improvements so that it's easier for lenders to make SBA-backed loans. We've simplified the guaranty purchase process, for one, and we've stepped up our lender support.

Many lenders have engaged in sub-prime business lending on their own, which has helped get more capital to small business owners that need it. But as delinquencies rise and lenders retreat from making loans to sub-prime small business borrowers, we see an important role for the SBA to provide a government guarantee that allows lenders to mitigate the risk. We've been telling lenders about the advantages that utilizing our products can offer.

We are also working to educate business borrowers. We recently added two finance courses – one is a primer on SBA's loan guaranty programs, the other on how to prepare a loan package – to our online Small Business Training Network.

The self-paced training programs introduce small business owners to basics of how our loan products can work for them.

In less than a week after the courses went live on the website, and without any advertising, the guide to SBA loan programs has reached almost 1,900 clients. And the course on preparing a loan package has reached more than 700.

Finally, I'd like to add that SBA has a differentiated presence in the lending community. We don't attempt to duplicate or to supplant the private sector in any way. Our role is to enhance what private sector lenders already do – to enable them to extend credit further than they otherwise would.

- We have a special role in helping entrepreneurs from specific demographic and geographic groups.
- And we can see this as we look at some of the results [Urban institute loan comparison]:
    - A dollar volume comparison shows that while only 6 percent of all conventional small business loan dollars went to start-up firms, 23 percent of SBA guarantied loan dollars did. So our guarantied loans were almost 4 times more likely to go to start-up firms than traditional small business loans.
    - And our guarantied loans were more than 5 times more likely to go to minority-owned firms than traditional small business loans. While only 5.5 percent of conventional small business loan dollars went to small businesses owned by minorities, 28.5 percent of SBA-guarantied loan dollars did.

    - If we look at women-owned small businesses, we see the same pattern: 4.4 percent of conventional small business loan dollars; 16.2 percent of SBA guarantied dollars.
- We know this because the Urban Institute, a well-respected Washington, D.C. based think tank, did a study, looking at loans between 2001 and 2004.
- So what we know from the Urban Institute data is that our loans are more likely to go to those markets that are more likely to have difficulty securing capital.
- We also have an important role in enabling small business ownership in economically distressed areas.
- We see a significant portion of our loan volume go to what we call underserved markets – areas of our country with higher than average poverty and unemployment. In Fiscal 2007, about one-third of our loans were made to underserved communities.
- Approximately 15 percent of the loans we guaranteed in the last fiscal year were made to companies in inner city communities.

These inner city communities, and other economically distressed communities, are also where we are seeing a disproportionate impact from the housing crisis. These communities have a higher percentage of home foreclosures. And in so much as SBA's ability to augment business lending will be ineffective while borrowers in these communities face housing troubles, it's clear that the future of sub-prime business lending will be tied to sub-prime mortgage lending.
In closing, I'd like to say that despite the current trends I mentioned, we have the deepest capital market in the world. SBA's products enable the private sector to reach further in ways which benefit viable entrepreneurs that have difficulty getting access to capital.

And this, in turn, enables entrepreneurs to start or expand businesses…to create jobs and new opportunities…to drive economic growth…and to empower lasting, positive change in every community across the country.